

## **103 KAR 16:340. Apportionment and allocation; completed contract method.**

RELATES TO: KRS 141.120.

STATUTORY AUTHORITY: KRS 131.130(1), 141.120

NECESSITY, FUNCTION, AND CONFORMITY: KRS 141.120 provides for the division of income of interstate business for tax purposes. KRS 131.130(1) authorizes the department to promulgate administrative regulations to administer and interpret Kentucky's tax laws. This administrative regulation explains how the business income apportionment factors shall be calculated when net income is reported on a completed contract basis.

Section 1. Definitions. (1) "Completed contract method of accounting" means a method of accounting whereby business income from long-term contracts is reported for the taxable year in which the contract is finally completed and accepted.

(2) "Long-term contracts" means contracts covering a period in excess of one (1) year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

Section 2. General. If a corporation uses the completed contract method of accounting, the business income earned within Kentucky shall be determined by a weighted fraction, the numerator of which is the weighted sales factor fifty (50) percent, plus the weighted property factor twenty-five (25) percent plus the weighted payroll factor twenty-five (25) percent, and the denominator of which is four (4), as modified by the following special rules for business income derived from long term contracts established in Sections 3 to 7 of this administrative regulation.

Section 3. Sales Factor. The numerator and denominator of the sales factor shall be determined pursuant to KRS 141.120(8)(c) and the following special rules:

(1) Gross receipts derived from the performance of a contract shall be attributable to Kentucky if the construction project is located in Kentucky. If the construction project is located partly within and partly without Kentucky, the gross receipts attributable to Kentucky shall be based upon the ratio which construction costs for the project in Kentucky incurred during the taxable year bear to the total of construction costs for the entire project during the taxable year.

(2) The sales factor shall include the portion of the gross receipts (progress billings) received or accrued, whichever is applicable, during the taxable year attributable to each contract.

Section 4. Property Factor. The numerator and denominator of the property factor shall be determined pursuant to KRS 141.120(8)(a) and the following special rules:

(1) The average value of the corporation's cost (including materials and labor) of construction in progress, to the extent that the costs exceed progress billing (accrued or received, depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts), shall be included in the denominator of the property factor.

(2) The value of any construction costs attributable to construction projects in this state shall be included in the numerator of the property factor.

(3) Rent paid for the use of equipment directly attributable to a particular construction project shall be included in the property factor at eight (8) times the net annual rental rate even though the rental expense may be capitalized into the cost of construction.

Section 5. Payroll Factor. The numerator and denominator of the payroll factor shall be determined pursuant to KRS 141.120(8)(b) and the following special rules:

(1) Compensation paid employees which is attributable to a particular construction project shall be included in the payroll factor even though capitalized into the cost of construction.

(2) Compensation paid employees who, in the aggregate, perform most of their services in a state to which their employer does not report them for unemployment tax purposes, shall be attributable to the state in which the services are performed.

Section 6. (1) The completed contract method of accounting shall require that the reporting of income (or loss) be deferred until the year in which the construction project is completed or accepted.

(2) Accordingly, a separate computation shall be made for each contract completed during the taxable year, regardless of whether the project is located within or without Kentucky, to determine the amount of income which is attributable to sources within Kentucky.

(3) The amount of income from each contract completed during the taxable year apportioned to this state, plus other business income apportioned to this state by the regular three (3) factor formula such as interest income, rents, royalties, income from short-term contracts, etc., plus all nonbusiness income allocated to Kentucky, shall be the measure of tax for the taxable year.

(4) The amount of income (or loss) from each contract which is derived from sources within Kentucky using the completed contract method of accounting shall be computed as follows:

(a) In the taxable year in which the contract is completed, the income (or loss) therefrom shall be determined.

(b) The income (or loss) determined by paragraph (a) of this subsection shall be apportioned to Kentucky by the following method:

1. A fraction shall be determined for each year during which the contract was in progress. The numerator shall be the amount of construction costs paid or accrued in each year during which the contract was in progress and the denominator shall be the total of all construction costs for the project.

2. Each percentage determined by subparagraph 1 of this paragraph shall be multiplied by the apportionment formula percentage for that particular year as determined in Section 2 of this administrative regulation.

3. The percentages determined by subparagraph 2 of this paragraph for each year during which the contract was in progress shall be totaled. The amount of total income (or loss) from the contract determined under paragraph (a) of this subsection shall be multiplied by the total percentage. The resulting income (or loss) shall be the amount of business income from the contract derived from sources within Kentucky.

Section 7. Computation for Year of Withdrawal, Dissolution or Cessation of Business. (1) Use of the completed contract method of accounting shall require that income derived from sources within Kentucky from incomplete contracts in progress outside Kentucky on the date of withdrawal, dissolution or cessation of business in Kentucky be included in the measure of tax for the taxable year during which the corporation withdraws, dissolves or ceases doing business in this state.

(2) The amount of income (or loss) from each contract to be apportioned to Kentucky by the apportionment method established in Section 6(4)(b) of this administrative regulation of this administrative regulation shall be determined as follows:

(a) The amount of business income (or loss) for each contract shall be the amount by which the gross contract price from each contract which corresponds to the percentage of the entire contract which has been completed from the commencement thereof to the date of withdrawal,

dissolution, or cessation of business exceeds all expenditures made during the period in connection with each contract.

(b) In so doing, account shall be taken of the material and supplies on hand at the beginning and end of the taxable year for use in each contract. (32 Ky.R. 2204; 33 Ky.R. 76; eff. 8-7-2006.)